

## Message Text

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ACTION NEA-07

INFO OCT-01 SS-14 ISO-00 IGA-01 EB-04 NSC-05 NSCE-00  
CIAE-00 INR-05 TRSE-00 SP-02 OMB-01 L-01 H-01  
PM-03 DODE-00 SIL-01 /046 W  
-----101508Z 018129 /45

R 101146Z JUN 77  
FM AMEMBASSY TEL AVIV  
TO SECSTATE WASHDC 6623

C O N F I D E N T I A L SECTION 1 OF 2 TEL AVIV 4165

LIMDIS

E.O. 11652: GDS  
TAGS: EAID, IS  
SUBJECT: FY 79 SECURITY SUPPORTING ASSISTANCE TO ISRAEL

REFS: (A) STATE 84323 (B) TEL AVIV 760 (C) TEL AVIV 4279

1. SUMMARY. THE CURRENT UNCERTAINTIES IN THE ISRAELI ECONOMY AND POLITICAL SCENE MAKE FORECASTING AND THE FORMULATION OF AID RECOMMENDATIONS MORE HAZARDOUS THAN USUAL. WHILE LIKUD LEADERS SPEAK OF RATIONALIZATION, GREATER RELIANCE ON THE PRIVATE SECTOR, AND CUTS IN PUBLIC SPENDING, IT'S TOO EARLY TO KNOW WHAT ECONOMIC POLICIES THE NEW GOVERNMENT WILL ADOPT, LET ALONE HOW SUCCESSFUL IT WILL BE IN IMPLEMENTING THEM.

2. INFORMATION AVAILABLE TO US SUGGESTS THAT THE SLOW UPTURN IN ECONOMIC ACTIVITY IS CONTINUING, SPURRED BY EXPORTS AND HIGHER PRIVATE CONSUMPTION. ON THE OTHER HAND, THE CENTRAL ECONOMIC PROBLEMS--BOP DEFICIT AND INFLATION--ARE LIKELY TO REGISTER ONLY LIMITED IMPROVEMENT THIS YEAR. THE NEXT GOVERNMENT CAN BE EXPECTED TO REQUEST A CONTINUATION OF ANNUAL U.S. ASSISTANCE IN THE \$2 BILLION RANGE. WE BELIEVE THAT  
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AID AT THIS LEVEL IS NOT JUSTIFIED AND THAT THE ECONOMIC PORTION OF THE AID PACKAGE SHOULD BE GRADUALLY PHASED OUT IN LINE WITH THE OFT-STATED GOI OBJECTIVE ELIMINATING THE NEED FOR ECONOMIC ASSISTANCE BY 1980. END SUMMARY.

3. ASSESSMENT AND PROJECTION OF THE ECONOMY. FOLLOWING

THE 1973 ISRAEL-ARAB WAR AND THE WORLDWIDE FOOD-FUEL PRICE EXPLOSION, ISRAEL'S ECONOMY FELL ON DIFFICULT TIMES. THE IMPORT REQUIREMENTS OF A HEAVY MILITARY BUILD-UP AND WORSENING TERMS OF TRADE CAUSED THE BALANCE OF PAYMENTS DEFICIT TO SURGE TO \$4 BILLION BY 1975. THIS DEFICIT WAS BEYOND THE CAPABILITY OF THE ECONOMY TO FINANCE, WITH MASSIVE (AND PROBABLY POLITICALLY UNACCEPTABLE) STRUCTURAL CHANGES, AND MOST OF THE INCREASE HAS BEEN FINANCED BY LOANS AND GRANTS FROM THE US GOVERNMENT. NEVERTHELESS, BALANCE OF PAYMENTS IMPROVEMENT BECAME THE BASIC GOAL OF ECONOMIC POLICYMAKERS. THE ISRAELI GOVERNMENT SHARPLY CURTAILED ECONOMIC GROWTH WHICH, COUPLED WITH ONLY HALF-HEARTED ATTEMPTS AT AUSTERITY AND A LINGERING SOCIALIST RELUCTANCE TO APPEAR TO HURT LABOR AT THE EXPENSE OF CAPITAL, CAUSED A HOST OF OTHER PROBLEMS, CHIEF AMONG THEM INFLATION, LOW PRODUCTIVITY, AND PRECARIOUS SHORT-TERM DEBT-RESERVE POSITION. IN ITS EFFORT TO MOVE RESOURCES TO THE EXPORT SECTOR, MOREOVER, THE GOVERNMENT COULD NOT USE THE STICK OF UNEMPLOYMENT TO GO WITH THE CARROT OF EXPORT INCENTIVES. UNEMPLOYMENT HAD RISEN ONLY TO FOUR PERCENT BY YEAR-END 1976, ABOUT THE LEVEL OF FULL EMPLOYMENT FOR ISRAEL. ALTHOUGH THE NATIONAL BUDGET PREDICTS AN AVERAGE UNEMPLOYMENT RATE OF FIVE PERCENT FOR 1977, WE SERIOUSLY DOUBT THAT EVEN A LIKUD GOVERNMENT WILL LET IT RISE SO HIGH.

4. THE ECONOMIC CYCLE NEVERTHELESS APPEARS TO HAVE  
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BOTTOMED OUT IN 1976, WITH IMPROVEMENT REGISTERED IN BOTH THE INDUSTRIAL PRODUCTION AND BALANCE OF PAYMENTS AREAS. CREEPING DEVALUATIONS, DESIGNED TO OFFSET THE DIFFERENT INFLATION RATES BETWEEN ISRAEL AND ITS TRADING PARTNERS, COMBINED WITH EXPORT INCENTIVES SUCH AS SUBSIDIZED LOANS, TAX REBATES, AND MULTIPLE EXCHANGE RATES, HELPED EXPAND EXPORTS. THESE EFFORTS, PLUS A DELAY IN SOME DEFENSE IMPORTS, ENABLED ISRAEL TO REDUCE ITS GOODS AND SERVICES ACCOUNT DEFICIT TO \$3.3 BILLION IN 1976. INFLATION REMAINS A MAJOR PROBLEM. ALTHOUGH WITH SUBSTANTIAL INDEXATION MOST GROUPS HAVE LEARNED TO LIVE WITH RAPID PRICE INCREASES, THE 1976 RISE OF 38 PERCENT IN THE CPI BROUGHT THE INFLATION RATE TO AN UNACCEPTABLE LEVEL. YET, THE WAGE HIKES WON IN THE PRE-ELECTION PERIOD FROM A WEAK LABOR GOVERNMENT HAVE ALREADY SET FORCES IN MOTION WHICH ARE LIKELY TO RAISE THE INFLATION RATE ABOVE 30 PERCENT. ALTHOUGH LIKUD LEADERS HAVE PROMISED TO MOVE RESOLUTELY TO

REDUCE INFLATION, THE NEW GOVERNMENT'S EFFORTS  
MAY BE WEAKENED BY THE LIKUD PLEDGE TO  
ELIMINATE SUBSIDIES ON CONSUMPTION AND TO  
RATIONALIZE THE INDIRECT TAX SYSTE.

5. ISRAEL'S DEBT-RESERVE POSITION MARKEDLY IMPROVED  
IN 1976. AT THE END OF 1975, ISRAEL HAD SHORT-TERM  
DEBT OF \$927 MILLION AND RESERVES (IMF DEFINITION)  
OF \$1.18 BILLION. ?6 -048) 30, 1977, SHORT-TERM  
FOREIGN DEBT HAD DROPPED BELOW \$800 MILLION AND  
RESERVES WERE UP TO \$1.45 BILLION AND RISING AT  
A RATE OF \$20 MILLION PER MONTH. REAL PUBLIC  
CONSUMPTION FELL BY EIGHT PERCENT IN 1976. HOWEVER,  
THE GOVERNMENT DOMESTIC DEFICIT INCREASED BY 44  
PERCENT; BUDGETARY POLICY OVERALL WAS THUS  
EXPANSIONARY, WITH RESULTING RISES IN INTEREST RATES  
AND PRIVATE CONSUMPTION.  
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6. PROSPECTIVE MEMBERS OF THE NEW GOVERNMENT HAVE  
STRESSED, IN ADDITION TO THEIR DETERMINATION TO  
REDUCE INFLATION, THEIR INTENTION OF ACHIEVING

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PM-03 DODE-00 SIL-01 /046 W  
-----101511Z 018509 /45

R 101146Z JUN 77  
FM AMEMBASSY TEL AVIV  
TO SECSTATE WASHDC 6624

C O N F I D E N T I A L SECTION 2 OF 2 TEL AVIV 4165

LIMDIS

HIGHER GROWTH THROUGH GREATER EMPHASIS ON THE PRIVATE

SECTOR AND "FREE MARKET FORCES." THE LIKUD'S ECONOMIC PLATFORM, MOREOVER, CALLS FOR REDUCING THE TOTAL BOP DEFICIT FROM \$3.3 BILLION IN 1976 TO \$1.5 BILLION WITHIN FIVE YEARS. WHILE THEY HAVE BEEN LESS THAN PRECISE IN SUGGESTING HOW THIS WILL BE DONE, IT IS TO BE HOPED THAT THEY CAN AT LEAST MAKE A START TOWARD MORE EFFICIENT USE OF RESOURCES WHICH SHOULD, IN TURN, ENABLE THE GOVERNMENT TO GET A BETTER GRIP ON INFLATION AND THE PAYMENTS DEFICIT.

7. REQUIREMENTS FOR AID. WE CONCEIVE OF OUR RECENT ASSISTANCE PROGRAMS TO ISRAEL AS PASSING THROUGH SEVERAL STAGES. IN THE EARLY POST-1973 PERIOD, WE WERE ESSENTIALLY HELPING ISRAEL FINANCE ITS MILITARY BUILD-UP AND CERTAIN ADDITIONAL IMPORT REQUIREMENTS (PRIMARILY OIL). OUR AID WAS ALSO INTENDED TO ASSIST IN BRINGING ABOUT STRUCTURAL CHANGES AND THE RESUMPTION OF BROAD-BASED GROWTH. SOME LIMITED PROGRESS HAS BEEN MADE. ISRAEL CONTINUES TO IMPROVE ITS CASH-FLOW POSITION AND HAS ALLOTTED FIRST PRIORITY TO IMPROVING ITS SHORT-TERM DEBT-RESERVE RATIO. FROM OUR POINT OF VIEW, THIS USE

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OF AN AID-GENERATED SURPLUS IS PREFERABLE TO SPENDING MORE ON IMPORTS WHILE REMAINING IN A DIFFICULT SHORT-TERM POSITION. HOWEVER, WE FEEL THAT BY 1980 THE GOI CAN MAKE THIS CHOICE WITHOUT U.S. ECONOMIC ASSISTANCE.

8. OUR IN-HOUSE PROJECTIONS ON ISRAEL'S CIVIL SECTOR BALANCE OF PAYMENTS SHOW THE CIVIL SECTOR FINANCE GAP BECOMING POSITIVE AT LEAST BY CALENDAR YEAR 1978, USING FAIRLY CONSERVATIVE ASSUMPTIONS. WITH U.S. ASSISTANCE CONTINUING AT CURRENT LEVELS, WE FORESEE A SURPLUS ON CIVIL ACCOUNT OF OVER \$1 BILLION IN THAT YEAR. DETAILS OF THE PROJECTIONS ARE BEING FORWARDED TO NEA AND AID. PRELIMINARY ESTIMATES FOR THE FIRST FIVE MONTHS OF 1977 SHOW A 26 PERCENT MERCHANDISE EXPORT RISE OVER THE SAME PERIOD LAST YEAR. IMPORT FIGURES ARE NOT YET AVAILABLE, BUT EVEN TAKING THE RATHER PESSIMISTIC NATIONAL BUDGET PROJECTION OF 10 PERCENT INCREASE, THE TRADE BALANCE IMPROVEMENT SHOULD KEEP ITS MOMENTUM.

9. WE ARE CONCERNED THAT THE ISRAELI PERCEPTION OF OUR ASSISTANCE PROGRAM HAS UNDERGONE A RATCHET EFFECT OVER RECENT YEARS SO THAT PLANNING IS MADE UNDER WHAT MIGHT BE CALLED A "PERMANENT AID HYPOTHESIS." THERE IS AN ASSUMPTION THAT U.S. AND ISRAEL AID DISCUSSIONS

CONCERN ONLY INCREMENTS AROUND THE \$2 BILLION TREND LINE. THE EMBASSY BELIEVES THAT WE SHOULD TAKE THE GOI AT ITS WORD WHEN IT SAYS THAT IT CAN CUT ITS BOP DEFICIT TO THE POINT THAT CIVILIAN AID WILL NOT BE NECESSARY AFTER 1980. WE SHOULD INDICATE FIRMLY TO THE GOI THAT BASED ON OUR PROJECTION OF ISRAEL'S ECONOMY AND FINANCING REQUIREMENTS, THE CIVILIAN ASSISTANCE PROGRAM WILL BE SHARPLY REDUCED IN FY 1979 AND ELIMINATED BY FY 1980.

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10. RECOMMENDED SUPPORTING ASSISTANCE FOR FY 79. TAKING INTO ACCOUNT THE INSTRUCTIONS IN REF C, CIP AND CASH GRANT RECOMMENDATIONS ARE LISTED WITH MINIMUM, CURRENT, AND PROPOSED LEVELS OF EXPENDITURE. CURRENT LEVELS ARE FY 78 AS SUBMITTED TO CONGRESS. OUR COMMENTS IN REFS B AND C ON OTHER ELEMENTS IN THE TOTAL AID PACKAGE REMAIN VALID. THE IMPACT OF FMS FUNDING ON ISRAEL'S ECONOMY AND PLANS WILL BE DISCUSSED IN OUR REPLY TO STATE 129WEOM

11. COMMODITY IMPORT PROGRAM (CIP)

MINIMUM \$300 MILLION

CURRENT \$635 MILLION

PROPOSED \$400 MILLION

THE CIP HAS BEEN THE MAIN U.S. VEHICLE FOR FINANCING THE CIVIL BOP DEFICIT IN RECENT YEARS. WITH AN IMPROVING ISRAELI BOP PICTURE, WE CAN FIND LITTLE JUSTIFICATION FOR CONTINUING THE PROGRAM AT ITS PRESENT LEVEL. IN FACT, RECENT LEVELS OF CIP APPEAR TO HAVE BEEN TOO HIGH TO BE FULLY UTILIZED AND HAVE PERMITTED POSTPONEMENT OF LONG-OVERDUE POLICY MEASURES. THE CIP HAS NOT SIGNIFICANTLY ALTERED THE PATTERN OF ISRAELI IMPORTS, ALTHOUGH IT PROBABLY HELPED TO MAINTAIN THE U.S. MARKET SHARE. OUR RECOMMENDED LEVEL IS FIGURED ON THE BASIS OF THE BENEFIT TO U.S. EXPORTERS OF TIED ASSISTANCE AS WELL AS THE NEED FOR AN ORDERLY PHASE-DOWN OF ECONOMIC ASSISTANCE.

12. CASH GRANT PROGRAM

MINIMUM 0

CURRENT \$150 MILLION

PROPOSED 0

THE EMBASSY SEES NO JUSTIFICATION FOR CONTINUING THIS PROGRAM. AS NOTED IN TEL AVIV 3046, CASH IS FUNDIBLE AND CAN BE DIVERTED FROM FUNDING IDENTIFIABLE BOP NEEDS TO OTHERWISE, LESS DESIRABLE USED.

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THE LARGE BACKLOG OF UNSPENT CIP FUNDS SHOULD NOT  
BE SEEN AS JUSTIFICATION FOR CASH GRANTS.LEWIS

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## Message Attributes

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Margaret P. Grafeld  
Declassified/Released  
US Department of State  
EO Systematic Review  
22 May 2009  
**Markings:** Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 22 May 2009